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A Call to the SEC to Require Valuation Disclosure

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By Karl M. Sjogren, MBA, CPA

The Jumpstart Our Business Startups (JOBS) Act is a year old and we're still waiting to see how the U.S. Securities and Exchange Commission will implement it. In particular, it's "crowdfunding" provisions.

The JOBS Act makes it easier for companies to sell stock to investors who are wealthy (i.e., they meet the SEC's "accredited investor" standard) and also, potentially, to small investors. Purportedly, the delay is due to difficulty reconciling the JOBS Act with the SEC's mission to protect investors.

No matter how the law is implemented, I have a suggestion for how to protect investors that could also help companies compete for capital; require that all companies disclose the valuation that they give themselves when they offer stock.

Valuation is occasionally cited in news reports, such as this one comparing the anticipated valuation range for an initial public offering by Alibaba Group Holdings, a Chinese Internet company, to Facebook's.

> *Facebook's IPO valued the company at $104 billion (its market capitalization has since slipped back to $63 billion). Estimates of the likely valuation of Alibaba range from $55 billion to more than $120 billion.*

Many investors are unsure what valuation means. It is simply the price to buy the entire company, based on the latest price shares are sold at. When new shares are sold by an issuer, valuation refers to the "pre-money valuation". After the offering is complete (i.e., the money is collected and shares issued), it refers to "post-money valuation" or market capitalization.

Some investors know what pre-money valuation means but are unsure how to calculate it. Here's one way.

Pre-Money Valuation = Number of Shares Outstanding Before the Offering X Price of a New Share

For example, suppose ABC Company has 10 million shares outstanding and plans to issue 1 million new shares at $5.00 per share to raise $5 million. With these terms, the ABC gives itself a $50 million valuation (e.g., 10 million X $5.00).

Here is the relationship between ABC's pre-money and post-money valuation.

$ 50 million is ABC's "Pre-money" valuation (10 million shares X $5.00 per share)

<u>+ $ 5 million</u> is the "Money" raised in the offering (1 million shares X $5.00 per share)

= $55 million is ABC's "Post-money" valuation or market capitalization (11 million shares X $5.00 per share)

After the offering, if someone sells a share of ABC stock for $6.00, the company's valuation—its market capitalization—will rise from $55 million to $66 million (11 million shares X $6.00). Conversely, if the most recent share price is $4.00, ABC's valuation falls to $44 million (11 million shares X $4.00). Whether ABC is privately held or publicly traded, the calculation assumes that stock is sold at market value and that the latest price is the value of each share outstanding. Theoretically, it is what someone would pay to buy the entire company.

So, in setting its terms, ABC suggests that it is worth $50 million.

Maybe it is. Maybe it's isn't.

How might investors evaluate the price?

When investors know ABC's valuation, it is easy for them pose a fundamental question. "ABC has less than $1 million in revenue and no profit. Why should I invest when it is valued at $50 million?"

When investors do not know ABC's valuation, the pricing question will likely be "Why should I invest when it is $5.00 per share?" However, this is not meaningful; ABC could have the same valuation with a lower price and more shares.

The important price question is "Why is ABC worth $50 million?" This question is especially critical when an issuer is private—the kind of company the JOBS Act is designed for—because its stock does not trade in a market.

Valuation is important information and investors should not, as they do now, have the burden of calculating it. Some may not know how to. Others may be uncomfortable doing so or forget to. Some will calculate it incorrectly.

For venture capitalists, valuation is the most important consideration when evaluating an investment. Yes, they must feel that management is capable, that the company's market is attractive and that it has a compelling competitive advantage. However, if the valuation is too high, they don't buy.

Valuation disclosure will help data aggregators assemble valuation statistics for investors and companies that improve the efficiency in capital markets the same way that Kelly Blue Book improves efficiency in the car market and home listing data improves efficiency in the real estate market.

I also suggest that the SEC requires issuers to discuss factors they considered as they set their valuation and, perhaps, encourage them to suggest why the figure is appropriate. This would set the stage for issuers to compete for investors like merchants do for customers. Some may view this is as undignified, but this is what happens when markets are efficient.

Two negative consequences result from the present lack of a disclosure requirement: unsophisticated investors are more likely invest unwisely, and, issuers are less likely to compete for investors by offering better terms.

I know accredited investors who are uncomfortable calculating valuation and I am certain that most small investors would struggle if asked to. Some believe, mistakenly, that securities agencies "approve" an issuer's valuation.

Fact is, valuation is caveat emptor—buyer beware. Undoubtedly, more investors have lost more money because they overpaid for a stock than has been lost due to fraud. Valuation-unaware investors fuel valuation bubbles—they are more susceptible to "irrational exuberance".

Interestingly, entrepreneurs can be hurt by valuation-unaware investors too. Success at raising capital at a too-high valuation encourages them to be arrogant about OPM—Other People's Money—and/or naïve about future raises of capital.

The second negative consequence of the absence of a valuation disclosure requirement is weak competition for investors. Issuers are disinclined to compete on the basis of valuation because many investors don't know what it is. Plus, their legal counsel will advise them to not disclose valuation in offering documents because; a) it is not required, and b) disgruntled investors who sue may argue the company represented itself as being "worth" the valuation.

The result is that the market for equity capital is far less efficient than many other markets.

Grocery stores offer another analogy. Unit pricing helps shoppers evaluate and compare products. Where it's not present, shoppers must calculate price per pound, per ounce, etc. Some maybe too busy or uncomfortable to do so.

Nutritional Fact Panels take the analogy further. The disclosure of fiber, salt, sugar and fat in a serving encourages informed shopping, and, it encourages manufacturers to offer healthier products. It helps small companies compete against large ones with better known brands or aisle placement.

Similar dynamics are possible in equity securities.

Two things seem true. Implementation of the JOBS Act will encourage more companies to offer stock to a larger pool of valuation-unaware investors, and, markets enhance the quality of products when relevant information is readily available to buyers.

Valuation disclosure may sound esoteric, but it's not. The SEC requires issuers to disclose risk factors in offering documents. Sometimes, the result is pages of eye-glazing prose.

A requirement for valuation disclosure could be accomplished on one page and it would do more, I suspect, to protect investors. It would also enhance competition in the equity capital market-whether crowdfunded or not.

Post Script

Why doesn't the SEC require valuation disclosure? It's puzzled me, given the merits described above.

My speculation is that no constituency with a significant voice has called for it.

1) The general investing public doesn't know what it doesn't know (i.e., the importance of being valuation-aware), so they don't call for it.

2) Issuers are not anxious to see it. Neither are investment banks or broker-dealers.

3) Sophisticated investors and those favorably positioned to get allocations of IPO shares know how calculate it. Plus, they see no benefit if a wider pool of investors are similarly valuation-aware. After all, such investors are the ones most likely to bid up the price of shares that they hold.

4) Legislators are generally valuation-unaware, especially those inclined to be consumer advocates. Those who are valuation-aware are likely to be in group #2 above, and/or, see no benefit to advocating for something:

> a) for which there is little constituent demand, and
>
> b) that will inhibit the flow of campaign contributions (see #2 and 3).
>
> > On March 23, 2012, former SEC chairman Arthur Levitt interviewed then-current chairman of the SEC, Mary Schapiro, on his radio show, A Closer Look With Arthur Levitt [1]. Concluding a discussion about the failure of the congress to approve "self-funding" for the SEC, Mr. Levitt said the following.
> >
> > > *I guess I can afford to be more cynical now, Mary. I think that the reason you didn't get self-funding was because congress didn't want to give up the appropriation power over the agency. Because historically, it's 'self-funding' for them in terms of campaign contributions. I can say it now. You probably can't. Sit back and listen (chuckle).*

5) The SEC is has been underfunded as well as overworked for years; they are more likely to focus on immediate demands than to create new requirements. [2]

6) No SEC Chairman has championed valuation disclosure. (More on this at the bottom.)

7) Regulators tend to be attorneys, not financial experts that are attuned to making markets more efficient.

The last point came into focus as I read Professor James J. Angel testimony before House committees. At a March 30, 2011 hearing on the costs of implementing the Dodd-Frank Act, he said [3]:

> *The SEC is just getting around to measuring how many of its staffers have industry designations such as the Certified Fraud Examiner, Chartered Financial Analyst (CFA), or FINRA Series 7.*
>
> *Alas, in their FY 2010 annual report they were unable to report the number and reported it as N/A, and listed the goal for FY 2011 as "TBD".*
>
> *I searched the CFA Institute's directory and found that only about 60 CFA charter holders are listed as working for the SEC. How can the SEC really review the filings from over 35,000 registrants(public companies, mutual funds, RIAs, broker-dealers, transfer agents, securities exchanges, and rating agencies) with only 60 Chartered Financial Analysts?*
>
> *The SEC seems to be able to hire lots of lawyers, but not enough people with financial expertise.*

Professor Angel iterated this perspective on April 11, 2013 when he testified on the implementation of the JOBS Act. [4]

> *…the SEC has a long history of misallocating the resources that it has received. Rather than hiring experienced people with the financial and technical experience it needs to regulate today's complex high-tech markets, it has hired lots of attorneys who engage in hairsplitting minutia while missing the big picture.*
>
> *Don't get me wrong. My father and grandfather were attorneys. I actually like lawyers. They are interesting people and it is fun to get into intellectual debates with them.*
>
> *However, if you have a leaky pipe, you need a plumber, not a lawyer. The SEC needs to hire more market plumbers and fewer lawyers.*

Regarding the absence of a champion (point 6). New SEC Chairman Mary Jo White seems likely to champion stronger enforcement, however, she will also oversee full implementation of the JOBS Act. Therefore, I openly make the following (cheeky) suggestion.

> Dear Chairman White,
>
> Valuation awareness seems like sex education. Many acknowledge its benefits...but few want to provide it. As a result, people are left to their own devices, more at risk of unwise decisions.
>
> As Surgeon-General in the '80's, C. Everett Koop cut against convention and championed anti-smoking and safe sex awareness. The Associated Press says "Koop was the only surgeon general to become a household name".
>
> As you oversee implementation of the JOBS Act, I hope you adopt a page from Dr. Koop's playbook and champion education and disclosure about valuation, for the reasons described above. It would be a good way, I think, for an SEC Chairman to become a household name.
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> Respectfully,
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> Karl M Sjogren

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[1] http://www.bloomberg.com/news/2012-03-23/a-closer-look-with-arthur-levitt-sec-s-mary-schapiro-audio-.html

[2] http://clsbluesky.law.columbia.edu/2013/01/02/sec-enforcement-what-has-gone-wrong/

[3] http://financialservices.house.gov/media/pdf/033011angel.pdf

[4] http://smallbusiness.house.gov/uploadedfiles/4-11-2013_james_j__angel_testimony.pdf

Based in Oakland, CA, *Karl M Sjogren is a CFO for early-stage companies and those in a turnaround situation*. He blogs about the Fairshare Model, a performance-based capital structure for companies that seek venture capital via a public offering. He is writing a book to promote adoption of the Fairshare Model, a performance-based capital structure, by companies that seek to raise venture capital via a public offering. The Fairshare Model balances and aligns the interests of investors and employees. Visit www.fairsharemodel.com to learn more.